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In the Supreme Court of the United States

OCTOBER TERM, 1982

ESTHER C. DICKMAN AND ESTATE OF PAUL B. DICKMAN, DECEASED, G. WENDELL SMITH, PERSONAL REPRESENTATIVE,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF OF AMICUS CURIAE, D'ANCONA & PFLAUM, IN SUPPORT OF PETITIONERS

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INTEREST OF AMICUS CURIAE

Amicus curiae, D'Ancona & Pflaum, is a law firm with its principal office in Chicago, Illinois. A number of its clients are interested in the outcome of this proceeding because they are in a position substantially identical to that of the petitioners. Included among these clients are many who reside in the area encompassed by the Seventh Circuit and who relied on a prior decision by the Seventh Circuit which is contrary to the decision in this case by the Eleventh Circuit.

Both parties have consented to the filing of this brief, and their consents have been filed with the Clerk of this Court.

SUMMARY OF ARGUMENT

The Eleventh Circuit incorrectly decided that interest-free loans, repayable on demand, from parents to their son and a closely held corporation controlled by the lenders and their children, constitute taxable gifts, and improperly rejected prior holdings to the contrary by the Seventh Circuit, the Tax Court, and a district court.

The *Crown*[1] decision by the Seventh Circuit in 1978 wisely avoided two severe morasses which would be created by this Court's affirmance of the decision of the Eleventh Circuit:

(1) An unprecedented retroactivity because of the unique nature of limitations applicable to the gift tax and the nationwide scope of individual loans made in reliance on the *Crown* decision; and

(2) An unconscionable burden on the courts if they had to deal with the especially complex issue of determining appropriate interest rates on a case-by-case, and on a daily, basis.

If the Commissioner's position in this case is sustained, he will be free to assert gift tax deficiencies against most taxpayers who made interest-free loans at any time since the inception of the gift tax in 1932.

While the valuation issue is not technically before this Court, the method used by the Commissioner demonstrates why the imposition of a gift tax, if any, as a result of an interest-free demand loan, is appropriate only for congressional action. Here, the Commissioner has asserted interest rates which are (a) inconsistent with his only public announcement on the subject; (b) inconsistent with his inconsistent positions in the three other cases where he has raised the issue; (c) inconsistent with the rate he has established by regulation to be charged on loans between related business

[1] *Crown v. Commissioner*, 585 F.2d 234 (7th Cir. 1978), *aff'g* 67 T.C. 1060 (1977). The *amicus curiae* herein represented the taxpayer in that case.

entities for income tax purposes; and (d) in fact, a rate which would have been usurious under most state laws.

The decision of the Eleventh Circuit should be reversed.

ARGUMENT

I.

THE SCOPE OF RETROACTIVITY

A judicial decision creating imputed interest on demand loans is necessarily retroactive in effect, in contrast with legislative action which would only be prospective.

A. Limitations Applicable to the Gift Tax

Because of the unique limitations provisions of the gift tax laws, affirmance of the decision below may apply to gift tax periods all the way back to 1932.

(1) No gift tax limitations apply to any period for which no gift tax return was filed.[2] Few people file gift tax returns every year. Thus, for each year for which no gift tax return was filed, there is no limitations period.

Even more to the point, for the 40 calendar quarters between 1971 and 1981 (when quarterly, rather than annual, returns were required), it is extremely unlikely that any taxpayer filed a gift tax return every quarter. And each quarter for which no return was filed is open to retroactive assessment.

(2) Even as applied to periods for which a gift tax return was filed for other gifts, the usual 3-year limitations period does not apply and a 6-year limitations period applies if the imputed interest on the loan is more than 25% of the reported gifts.[3]

Six years have not yet expired since loans were made in reliance on the *Crown* decision in 1978.

(3) Even where a gift tax return was filed and the 6-year or 3-year limitations period has run, an unreported gift could still result in a higher tax in a subsequent year

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[2]I.R.C § 6501(c)(3).

[3]I.R.C. §§ 6501(e)(2) and 6501(a).

through the inclusion of the amount of the earlier year's gift in determining the tax bracket applicable to the subsequent gift.[4] This effect derives from the fact that the gift tax from 1932 to 1976 was cumulative, so that the tax paid for any period was computed by determining the tax based on all taxable gifts since 1932 and then subtracting the tax based on the taxable gifts for all prior periods.[5] This cumulative effect is now computed differently but continued under the unified rate schedule for gift and estate tax since 1976.[6]

B. Factual Background for a Retroactive Decision

Prior to the *Johnson*[7] decision in 1966, there were no court decisions or Internal Revenue Service rulings or regulations seeking to treat the making of a low- or no-interest demand loan as a gift. The Service's effort in the *Johnson* case was unsuccessful.

Only in 1973, while the *Crown* case was in process, did the Commissioner issue his non-acquiescence with *Johnson* and assert such a position as a general rule.[8] This position was expressly rejected by the Tax Court in *Crown* at the trial level in 1977,[9] and the rejection was sustained by the Seventh Circuit on appeal in 1978. The Commissioner did not seek *certiorari* in *Crown*, nor has he made any effort by proposed regulation or legislative proposal since *Crown* to reverse the effect of that decision.

Even in the massive changes of the gift tax law enacted by Congress in 1976 and 1981, no effort was made and no reported consideration was given to changing the rule laid down in *Crown*.

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[4]See *Daanen* v. *Commissioner*, 30 T.C.M. (CCH) 286, 294 (1971).

[5]I.R.C. §§ 2502, 2504 (Pre-1977).

[6]I.R.C. §§ 2502, 2504 (Post-1976).

[7]*Johnson* v. *United States*, 254 F. Supp 73 (N.D. Tex. 1966).

[8]Rev. Rul. 73-61, 1973-1 C.B. 408.

[9]*Crown* v. *Commissioner*, 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978).

However, since the 1977 and 1978 court decisions in *Crown*, hundreds of articles on interest-free demand loans have been published; every financial newsletter has recommended such loans; and banks throughout the country have actively promoted such loans between family members. As a result, in reliance on those decisions, it is an established fact that thousands and thousands of interest-free demand loans have been made, the practice becoming so widespread that the appellation "Crown loan" is commonplace in financial circles. (For the reasons and in the manner set forth in III C below, Congress can deal appropriately with whatever it may consider abuses involved in the promotion of interest-free loans.)

Thus, a retroactively effective decision by this Court, coupled with the open limitations periods unique to the gift tax, could result in an enormous number of tax assessments for past periods on taxpayers who relied in good faith on advice based on the *Crown* decision.

II.

DETERMINATION OF THE INTEREST RATE TO BE IMPUTED IN OPEN YEARS WOULD PLACE AN UNCONSCIONABLE BURDEN ON THE COURT SYSTEM

For all such taxpayers for all open years, the volume of back assessments could reasonably be expected to be very large. In each such case, the factual issue to be determined will be different from every other case. Where a low- or no-interest demand loan was made, if a gift at all, the gift would be that amount of interest which represents the fair market value of the use of the money loaned to the particular borrower which in turn, might depend upon such factors as the prevailing interest rate in the area, his creditworthiness, the purpose of the loan, the security for the loan, and whatever else the Commissioner or the taxpayer considered relevant.

The Commissioner recognized the problem of making such a determination in the present case by ignoring the fair market value of money to the particular borrower and asserting instead the statutory interest rate from time to time applicable to tax deficiencies.[10] The court below in this case avoided the issue by remanding the case to the Tax Court to determine applicable interest, thereby rejecting this approach of the Commissioner.

A. The Commissioner has Asserted Inconsistent Positions

In *Johnson*, the Commissioner proposed a 3½% rate—the rate then by regulatory table applicable to the valuation of future interests[11]—for valuing the interest-free use of loaned funds repayable on demand.

In *Crown*, the Commissioner claimed a 6% rate for valuing the demand loans, as more or less representing the then effective "prime rate."[12]

In Rev. Rul. 73-61, the Commissioner asserted an otherwise unspecified "value of the use of the money" for demand loans, and the future interest valuation table for valuing the interest-free use of loaned funds repayable at the end of a specified term (then and now, 6%).[13]

In this case, the Commissioner applied the statutory tax deficiency interest provisions to the demand loan (ranging from 6% to 9% for the periods involved, and up to 20% since), and the 6% future interest valuation table to the alleged term loan.[14]

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[10]I.R.C. § 6621. This rate is now adjusted each January 1 and July 1, based on the average prime rate during the 6-month period ending on the preceding September 30 and March 31, respectively, rounded to the nearest full percent.

[11]Treas. Reg. § 25.2512-5(f).

[12]See 67 T.C. at 1061.

[13]Treas. Reg. § 25.2512-9(f).

[14]41 T.C.M. (CCH) 620, 622-623 (1980).

In *La Rosa*, now pending in the Tax Court, the Commissioner is asserting rates from 23.08% to 31.10% for 1979 on demand loans—twice the prime rate—and rates from 12.5% to 23.1% for the preceding 5 years. These were "obtained by consulting with an expert witness," to quote the Answer filed by the Commissioner.[15]

B. "Fair" Imputed Interest is an Extremely Complex Factual Issue

First, the case-by-case determination of how much interest is to be imputed on a particular loan over a particular period is a valuation issue. Like all valuation issues, the decision depends on the facts of each case.

Although much information is available about all kinds of commercial interest rates, the facts necessary to value the right to use money on a day-by-day basis are unique to each case.

Also, it is increasingly well-established that "prime rate" is an artificial concept, not applicable even in most commercial lending situations. At its origin in 1933, the prime rate was the interest rate that a bank charged its most creditworthy customers for short-term loans.

By 1980, the making of below-prime rate loans had become so widespread that Congressman Reuss, Chairman of the House banking committee, requested Chairman Volcker of the Federal Reserve to make "an investigation and report concerning this entire situation," noting that "large corporate borrowers were obtaining loans as much as 6 percent under the prime rate."[16] The staff report submitted in response by Chairman Volcker confirmed the practice of

[15] *LaRosa* v. *Commissioner*, No. 29632-82 (T.C., pet. filed Dec. 22, 1982, ans. filed Feb. 28, 1983).

[16] *Conduct of Monetary Policy, Hearing before the House Comm. on Banking, Finance and Urban Affairs*, 96th Cong., 2nd Sess. 157 (Ser. no. 63, 1980).

below-prime lending by banks to both large and small borrowers.[17]

The following year, the Federal Reserve reported to the committee that during May, 1980, 60.7% of the commercial loans made by large New York banks were below the publicly announced prime rate, and that the average discount from prime was 4.26 percentage points.[18] The staff of the committee conducted an analysis of the loans made by the nation's ten largest banks and found that the prime rate had become "a murky, ill-defined term that rarely reflects the lowest rates available to corporate customers" and that "its meaning [had become] virtually destroyed by the various discounts employed secretly by much of the banking industry."[19]

The latest information available from the Federal Reserve shows that during the first week of November, 1982, 92.2% (in dollar amount) of all short-term commercial and industrial loans made by large banks were made at below-prime rates.[20] Nevertheless, banks have persisted in quoting an artificially high prime rate because of the potential loss of revenue from outstanding long-term loans which are at rates tied to prime.[21]

With the burden on the taxpayer to dispute the Commissioner's rates claimed in his deficiency notice, those taxpayers who could afford the cost of litigation would introduce a

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[17]*Id.* at 132-156.

[18]Staff of House Comm. on Banking, Finance and Urban Affairs, 97th Cong., 1st Sess. *An Analysis of Prime Rate Lending Practices at the Ten Largest United States Banks* 2 (Comm. Print 1981).

[19]*Id.* at 3 and 20.

[20]Board of Governors of the Federal Reserve System, *Survey of Terms of Bank Lending.* This survey is made regularly for the first week of the second month of each calendar quarter.

[21]Merris, *Prime Rate Updated,* Economic Perspectives 14 (Fed. Res. Bk. of Chgo., May/June 1978).

series of expert witnesses on actual lending rates used for individual loans by banks and others. The Commissioner would then have to meet this testimony with that of other experts, and a classic pattern of case-by-case valuation would be presented.

Here, however, the problem will be intensified. Imputed interest on demand loans cannot be figured on a single date like most valuation cases; *i.e.*, the date of death or the date of the gift. Rather, since the gift is alleged to occur each day repayment is not demanded, valuation must be a continuous determination over all the days, months and years the loan was outstanding. Even the announced "prime rate" frequently changes weekly;[22] testimony as to changes throughout the applicable period would be unconscionably detailed and complex.

The Tax Court is already concerned with the burden of valuation cases, as distinquished from interpreting or analyzing the tax laws. This is stated in many Tax Court opinions, but most effectively in *Buffalo Tool*[23] where the Tax Court said:

> "[W]e are left with only the pure factual issue, the value of each item of machinery as of March 21, 1973. As the Court repeatedly admonished counsel at trial, the issue is more properly suited for the give and take of the settlement process than adjudication. See *Messing* v. *Commissioner*, 48 T.C. at 512. The existing record reeks of stubbornness rather than flexibility on the part of both parties, based upon 'an overzealous effort *** to infuse a talismanic precision' into their respective views as to valuation. See *Messing* v. *Commissioner*, 48 T.C. at 512. We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement

[22]The prime rate changed 39 times during 1980. Board of Governors of the Federal Reserve System, *Annual Statistical Digest 1980* 75 (1981).

[23]*Buffalo Tool & Die Manufacturing Co.* v. *Commissioner*, 74 T.C. 441, 451-452 (1980).

which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort, and money by the parties and the Court—a process not likely to produce a better result . . . . If the parties insist on our valuing any or all of the assets, we will. We do not intend to avoid our responsibilities but instead seek to administer to them more efficiently—a factor which has become increasingly important in light of the constantly expanding workload of the Court."

This attitude was repeated in *Simmonds*[24] in 1980 where the Tax Court said:

"The valuation process is already a difficult and time-consuming drain on the Court's resources . . . ."

III.

CONSIDERATIONS TO BE WEIGHED BY CONGRESS

As stated earlier, for the past 5 years the Commissioner has made no effort to present these issues to Congress even though both the *Crown* and *Johnson* courts determined that this was the only appropriate resolution of the question. Rather, the Commissioner has continued his "back door" approach of seeking judicial legislation after 50 years of the gift tax in which demand loans at low- or no-interest were not treated as taxable gifts.

A. "Fair" Imputed Interest is a "Catch-22" Under State Usury Laws

If the present case is affirmed, a taxpayer making a demand loan and wishing to charge interest to avoid making a gift is in an untenable position. If he charges a "market-type" rate of interest, he violates the usury laws of most states; if he observes the usury laws, he has made a taxable gift.

This is not a business or commercial loan question. Business transactions are a long-established exception from

[24] *Simmonds Precision Products, Inc.* v. *Commissioner*, 75 T.C. 103, 123 (1980).

the scope of the gift tax and of most usury laws. Nor is this a problem of loans from controlled corporations to shareholders or executives. These the Internal Revenue Service seeks to reach through the income tax, albeit unsuccessfully (*Dean*[25] and its progeny).

Rather, loans at low- or no-interest occur only between people with a personal relationship, usually within a family. All three recorded cases are intra-family and, in reality, only within a family would such loans be made.

While state usury laws have been changed to keep pace with commercial interest rates, by and large the state usury rates applicable to non-business, individual loans still are considerably below any possible fair market value of the use of money. This appears to be true of most of the 50 states and specifically is true in the more commercially-active states of New York, California, Illinois, Michigan, Pennsylvania and Florida, and the District of Columbia.

Furthermore, since such a large past period is open for assessment, even such changes in the usury laws as may be applicable have consistently lagged far behind interest rates in the market place.

Congress alone has the power to supersede state usury laws if it deemed this issue sufficiently important to exercise this power.[26]

B. Whether to Impute Interest on Intra-family Loans is a Question of Public Policy

The Commissioner argues that a taxable event occurs whenever one member of a family loans money to another family member without charging a full economic price. The same principle would apply to a loan of anything of value.

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[25]*Dean* v. *Commissioner*, 35 T.C. 1083 (1961), *nonacq.*, 1973-2 C.B.4.

[26]Congress, for example, preempted state usury laws on certain business and agricultural loans made between April 1, 1980 and April 1, 1983 (Sections 511 and 512 of the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C.S. §§ 86a, 86a note (Law Coop. supp. 1982)).

If his position is sustained by this Court, the decision will make the existing gift tax law applicable to all intra-family "loan" or "free use" arrangements. This would automatically extend to the use of houses, apartments, cars, boats, among other things. Even the guarantee of a child's debt to enable him to obtain an advanced education or get started in business would be a taxable gift unless an appropriate fee for the use of the parent's credit were charged.

As applied to money, Congress may well conclude that an intra-family loan should not be required to take on the aspects of a commercial transaction. In fact, many family loans arise because the borrower (brother-in-law or child) is not sufficiently credit-worthy to borrow commercially (and in such case the imputed interest rate on a market value basis could easily be 50%). Indeed, the moral question goes all the way back to biblical days. *Deuteronomy*, Chapter XXIII, verse 20 states:

> "Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury . . . ."
>
> (In biblical research it is well-established that the word "usury" means any interest, not just excessive interest.)

C. Any Action by Congress Can be Selective; Judicial Action Cannot

Congress has previously faced the problem of legislating to create imputed interest.

After the Commissioner lost in his effort to obtain a court decision that interest should be imputed in installment sale situations,[27] Congress considered the matter and enacted Code Section 483. This section established a number of statutory exceptions from the new rules, reflecting congressional policy judgments as to the desirable scope of imputing interest in that area. Similarly, Congress may establish rules of inclusion and exclusion crafted to balance the competing goals of family integrity and the gift tax. In particular,

[27] *Brown* v. *Commissioner*, 37 T.C. 461 (1961), *aff'd*, 325 F. 2d 313 (9th Cir. 1963), *aff'd*, 380 U.S. 563 (1965).

Congress could specifically provide that if no-interest demand loans are made with commercially-borrowed funds, the lender will lose his interest deduction. This would be similar to the rule already established where loans at interest are made to acquire tax-exempt securities.[28] Indeed, even in the area of interest-free demand loans, this result is indicated in *Creel*,[29] one of the *Dean* line of cases.

D. Congressional Action Can Eliminate the Valuation Issue

When Congress enacted Section 483, it required the Commissioner to establish by regulation the interest rate to be imputed if inadequate interest was provided in the installment sale contract. Although the Commissioner can amend (and has amended) the regulation to change the stipulated rate prospectively from time to time, every taxpayer can readily follow the regulatory provisions and thereby eliminate any uncertainty as to what rate of interest should be imputed.

Again, when Congress was considering what interest might be imputed under Section 482 in transactions between related business entities, it used its authority to postpone action by the Commissioner over a 7-year period while the Commissioner evolved "safe-harbor" rules similar to those adopted under Section 483.

In both of these instances, the fixing of applicable rates of imputed interest eliminated the entire "valuation" problem and thus avoided the evidentiary morass inherent in judicial determination of applicable interest rates on a case-by-case, daily, basis.

Even more significant, our taxing system—which is the most successful system in the world in relying on self-

[28] I.R.C. § 265.

[29] *Creel* v. *Commissioner*, 72 T.C. 1173, 1179-1180 (1979), *aff'd sub nom. Martin* v. *Commissioner*, 649 F.2d 1133 (5th Cir. 1981).

assessment—can function properly only when the taxpayer can know and rely on the clarity of his obligations.[30] The practical effect of the decision below is thus unworkable and unfair.

CONCLUSION

It is respectfully submitted that the decision of the Court of Appeals below should be reversed, the action of the Tax Court in this case affirmed, and the issue left to appropriate congressional consideration.

Respectfully submitted,

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[30]If this Court should conclude that the holding of the Eleventh Circuit was correct, in view of the fact that thousands of taxpayers in the Seventh Circuit have made low- or no-interest loans in reliance on the *Crown* case, this Court's decision should be applied prospectively in the Seventh Circuit. See *Diedrich* v. *Commissioner*, 457 U.S. 191, ___ n. 10 (1982).